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Excessive debt accumulation was, of course, the reciprocal of the credit expansion that "heated" the prosperity. It was a prime ingredient in the financial condition that was to overtake a large sector of the economic system: illiquidity. It was, indeed, an illiquid, overexpanded colossus of debts, rather than an excessive money supply, on which the price structure of the late 1920s rested.

Melchior Palyi, *The Twilight of Gold*,
Henry Regnery Company, Chicago, 1972

THE DECLINE OF THE REAL ECONOMY

It is widely accepted that this economic downturn in the United States has different causes and patterns from all other postwar recessions. Yet the unique features of this recession have provoked scant consideration of their *implications*. Instead, the focus is almost exclusively on statistics. A few blips on the upside suffice to declare recovery. The ominous profits implosion of the last few years is ignored as a thing of the past. Euphoric new profit forecasts simply take their place.

In the following pages, we will explain why the great majority of economists incorrectly assess the true state of the U.S. economy. It is due to an American economic tradition of focusing on (often-questionable) statistics at the expense of theory. But this is a game of measurement without judgment.

It is as if a meteorologist were to focus exclusively on atmospheric pressure readings without noticing that his barometer is faulty… and oblivious to the great storm forming over his shoulder.

Instead, for our part, we look at the *structure* of the recession. And we will show that at its root is not the typical inventory de-stocking of most recessions; rather, it has been caused by deteriorating profits and plunging business fixed investment.

We will also examine the central role of investment in economic growth and explain why it is not obvious in the GDP numbers. Though consumption may claim a larger share of GDP, economic activity is ruled by business spending.

The implications are that as long as the prospects for investment remain dim, the hopes for a sustained recovery will be in vain.

NOT SEEING THE FOREST FOR THE TREES

In 1925, after his first visit to the United States, Friedrich Hayek published an article about "The Monetary Policy of the United States After the 1920 Crisis." In it he expressed his utter amazement about the methods of investigation that most American economists employ in research about the business cycle.

> *American economics has turned to an ever increasing extent away from purely theoretical research aimed at an understanding of economic activity… They do not begin from a definite, basic theoretical conception of the economic process, but content themselves with gaining as detailed as possible a picture of the typical course of the cycle…*
>
> *Drawing extensively on extremely detailed statistical series, it now seeks primarily to construct a picture of the path typically followed by all economic processes… It is their hope that, from the insights*

they thereby gain into the relative behavior into the individual branches of production, they will then be able to derive theories as to the nature of the interrelationships between them. The result is a type of symptomatology of the course of the cycle… The leading American scholar in this field, W.C. Mitchell, is also the acknowledged leader of the new trend.

For Hayek and most European economists,

the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based. To decide upon the most important problems of the Trade Cycle remains the task of theory; and whether the money and labour so freely expended on statistical research in late years will be repaid by the expected success depends primarily on whether the development of theoretical understanding keeps pace with the exploration of the facts.

We have recalled this bit of history of economic thinking about the business cycle in America because it throws some light on today's typical discussion. It is concerned overwhelmingly with describing economic conditions via statistics, often *polished* statistics — rather than using statistics as a tool in conjunction with theory to assess the economy's true state of health.

NOT YOUR "GARDEN-VARIETY" RECESSION

Pondering the U.S. economy's prospects, we deem two features to be of foremost importance. One is the prolonged profit implosion, which has hit the manufacturing sector with devastating force. The other is the fact that the recession was not caused, as usual, by money and credit stringency. For the first time in history, the economy and stock market have slumped against the backdrop of rampant money and credit creation.

These unprecedented experiences raise some highly critical questions: Why has the deluge of money and credit failed to boost the economy and financial markets in any significant way? And what, exactly, is behind the U.S. economy's miserable profit performance? These are the two most important questions to scrutinize.

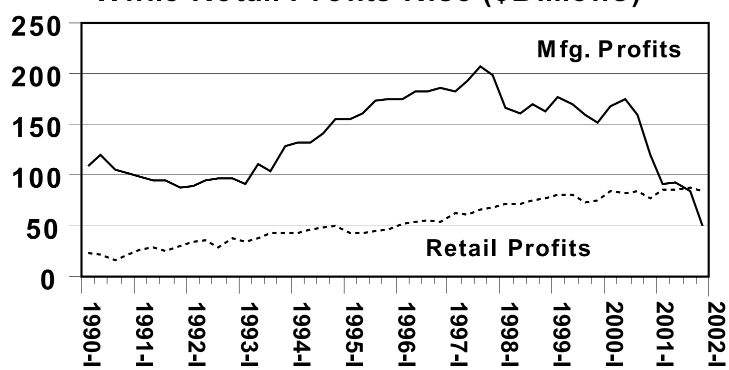
All previous postwar recessions were of the so-called "garden-variety" pattern, in that they mainly reflected a temporary inventory liquidation. Once this had been accomplished and the Fed eased in response to lower inflation rates, the economy promptly took off in a steep trajectory.

Inventory liquidations *did* contribute substantially to the U.S. economy's downturn last year. Yet its overwhelming source was an unusually steep plunge of business fixed capital investment.

Looking for the cause of the unfolding capital spending crisis amid double-digit money and credit growth, there is but one reasonable explanation: the profits implosion. It began in the fourth quarter of 2000, while the dive of fixed capital investment began just two quarters later.

Corporate profits of the nonfinancial sector as a whole peaked in the second quarter of 2000 at $518 billion, annualized. By the fourth quarter of 2001, they were down 44.4%, to $287.7 billion. Manufacturing, meanwhile, earned $175 billion during the second quarter of 2000. That dropped 71.2% — to $50.3 billion — by the fourth quarter of last year. During the same period, however, retail-trade profits edged up from $83 billion to $84.3 billion.

Manufacturing Profits Dive While Retail Profits Rise ($Billions)



Source: Rockville Research

This profits pattern is, of course, the exact mirror image of what has been happening in the economy. The worst-ever profits crisis in production coincides with debt-fueled booming consumption. Conspicuously, the consumption boom failed to prevent the profits disaster.

THE CHASM BETWEEN REALITY AND POPULAR EXPECTATIONS

While downward spiraling profits promptly ravaged business fixed investment, the stock market abides in unflinching denial. Yet this is hardly astonishing. Cuts in business fixed investment are dictated by the hard facts of the profits carnage. Investor outlook is largely determined by the popular media — and they mostly report the familiar illusions and delusions that the economists and the analysts of the financial community produce in abundance.

The fact is that after the Sept. 11-related dip, U.S. economic data have shown many signs of improvement, in particular after the turn of the year. In March, consumer confidence posted its largest jump in 11 years. Similarly, the Conference Board's index of leading indicators and the National Association of Purchasing Management's composite index of manufacturing activity have scored significant advances.

Monetary growth has kept booming, and the stock market has sharply rebounded. Together with the better-than-expected GDP data for the fourth quarter, this was immediate, conclusive proof for the large, bullish community of the U.S. economy's impending recovery.

Identifying considerable statistical fudge in the fourth-quarter GDP numbers, we discarded the recovery forecasts as bogus. But there is a second reason for our strongly opposing view.

It lies in the fact that the causes and pattern of the present U.S. economic downturn are fundamentally different from past experience. Yet the general focus is exclusively on the symptoms of the conventional inventory recessions of the past. There is zero appraisal of the unusual features of this downturn, such as the profits implosion and badly ravaged balance sheets.

Our analysis is, therefore, strictly focused on those aggregates in the economy that have started this economic downturn, which, by the way, business cycle theory regards as the key determinants of economic growth. These are profits and fixed capital investment. Changes in inventories exert only temporary influences.

So far, policymakers and Wall Street have been very successful in deluding the public into the belief that the U.S. economy has no serious problems. In our view, though, it is grossly misplaced confidence. While confidence is very important, we should distinguish between reasonable and unreasonable confidence.

History and logic argue that policymakers should beware of creating expectations that are sure to be disappointed. Such confidence games may buy some time, but the longer the borrowing and spending excesses last, the worse the eventual bust. Severe disappointment has been the typical harbinger of the great economic and financial crashes in history.

It is an old adage that history repeats itself because people never change. What we now hear and read about the U.S. economy's imminent recovery reminds us vividly of what happened after the stock market crash of 1929-30.

DÉJÀ VU

After the stock market crashed in late October/early November 1929, it rallied sharply until mid-April 1930. During this period, the consensus discarded the market's prior plunge as a healthy correction in a basically healthy economy. By early spring 1930, the economy seemed to be gaining strength, and the economic "correction" was considered over.

Both the earlier market crash and the economy's slowdown were thought of simply as one more pause on

the endless road to prosperity. There had been economic declines of greater magnitude in 1924 and 1926-27, and most observers expected more temporary declines to come in the future. Yet very few regarded the stock market crash as a serious event.

In fact, economic news was overwhelmingly encouraging. In this atmosphere, there happened an incident involving then-President Herbert Hoover that went into history books. The following is a quote from *The Memoirs of Herbert Hoover:*

> The New York Times *announced on February 12, 1930 that the country's economy had begun to recover. The economic indexes confirmed this hope. During the next weeks they continued to grow even more favourable. There were significant increases in the demand for steel and other raw materials. Construction work generally was reviving, even surpassing the normal.*
>
> *In* consequence *of these favourable indications, on May 1st (1930) I addressed the United States Chamber of Commerce, the major purpose being to express appreciation of the cooperation we had received from the business world, and to urge its continuance I indulged in some moderate optimism saying, "We are not through the difficulties of our situation, but I am convinced we have passed the worst and with continued effort we shall rapidly recover."*

And this from Arthur M. Schlesinger's *The Age of Roosevelt, The Crisis of the Old Order:*

> *On March 7, in his most detailed statement on the economic situation, President Herbert Hoover declared… that employment had been slowly increasing since the low point in December; that businesses and the state governments were spending more for construction than even in 1929.* ***"All the evidence indicates that the worst effects of the crash upon unemployment will have been passed during the next sixty days."***

Mr. Schlesinger's comment on this remark rings very true to us for the present situation:

> *Hoover's position was not an easy one. He had rightly decided that he could not indulge in a public pessimism that would only feed the panic. His fault lay not in taking an optimistic line, but in bending the facts to sustain his optimism and then in believing his own conclusions. For despite the presidential exhortations, private spending was simply not maintaining 1929 levels.*

In J.K. Galbraith's words: ***"There has been more optimism talked and less practiced than at any time in our history."***

Back to the present: To assess the U.S. economy's prospects in 2001-2002, let's start with a brief look at the extremely unbalanced pattern of its downturn.

UNSUSTAINABLE GROWTH

Current-dollar GDP grew by $235.4 billion from the fourth quarter of 2000 to the fourth quarter of 2001. That growth largely resulted from a rise in personal consumption of $306.8 billion (accounting for 130% of total growth) and a $113.6 billion jump in government spending. Against these gains, there were three major decreases: A $109.5 billion decline in business fixed investment, a $77.1 billion drop in net exports and a $59.4 billion fall for inventories.

This downturn pattern has no precedent in the whole postwar period. Investment spending is unusually weak and consumer spending unusually strong. Yet this pattern has at least one ominous parallel, but before World War II: the U.S. economy of 1926-29.

During the latter phase of the bubble years of the 1920s, consumer spending accounted for total GDP

growth. Despite soaring stock prices, the growth of business fixed investment and residential building had already come to a halt by 1926.

Apparently, only the booming stock market, with its attendant wealth effects, boosted consumer spending during these years. This helped keep industrial production at high levels. Yet investment spending remained weak, and by 1929-30 its negative effects overwhelmed the consumption boom. After all, it led to the single most dramatic change in 1930 that ushered in the Depression: Business profits literally collapsed.

Today, considering that fixed capital investment is not only stagnant but plummeting, there can be no doubt that it will again defeat the bullish consumer.

THE CONSUMER DETHRONED

In America, traditional economic thinking has it that the most important element of the economy's demand is consumer spending. There is an underlying view that as long as there is sufficient consumer demand, everything else, like profit and investment spending, will take care of itself. Taken literally, this perception of the overriding role of consumption in the economic growth process implies reasonable disregard of anything else. In fact, disregard of profits and capital investment is the essence of American economics. Profits and the prospect for profits are almost solely of interest with respect to the stock market.

There appear to be two principal reasons the great majority of American economists emphasize the role of consumer spending in economic growth. One is its big share of gross domestic product, lately accounting for 77% of GDP, against 12% for business fixed investment.

The other is the thought that consumption is the demand for the "final" product. And isn't that, after all, the ultimate reason of all economic activity? The flip side to this idea, by the way, is the notion that investment spending is basically the response of businesses to actual and expected increases in overall demand, of which consumer spending is by far the biggest component.

But this conventional way of measuring the importance of consumer spending for the economy overlooks two crucial aspects.

First of all, different types of expenditures have very different pushing power on the level of overall economic activity. Capital expenditures have the largest impact, with magnified effects on profits and consumer incomes via the so-called multiplier. By contrast, consumer spending on services has the smallest overall effects, lacking any longer-run effects.

Second, the conventional GDP data are not a true reflection of the economic structure. Principally, they capture only the spending on goods and services for final use. In this phrase, the word ***"final"*** is all-important. Since total consumer spending ranks, by definition, as final demand, it gets a weight far above its importance.

In the case of business outlays, the GDP accounts differentiate between two kinds of spending: on "*final* goods" and on "*intermediate* goods." None of the latter is included in GDP. This term refers to the output of all industries and services that produce raw materials or semi-finished materials for the production of final consumer or capital goods.

For example, heating oil and electricity delivered to the consumer increase GDP. Yet the huge deliveries to businesses are left out of the account. The logic behind this difference in statistical treatment is to avoid double counting. But one of the results is a grossly distorted picture of overall economic activity. As a result, business outlays enter GDP accounts as a net figure, capturing only the very small part being spent on final, finished plants and machinery.

The problem with this statistical treatment of "intermediate inputs" is that it virtually ignores the greatest

part of business outlays. Yet their production absorbs financial and real resources in the same way as final goods do. In the same vein, their production is a main source of employment and consumer incomes. What's more, business demand for intermediate inputs is subject to the obligatory profit calculations.

We have elaborated on these statistical intricacies in order to debunk the widespread perception that consumer spending is the most important component of the demand side of our economies. Taking intermediate inputs into account, overall business outlays effectively vastly exceed total consumer spending. In fact, isn't business spending the source of all incomes?

BUSINESS SPENDING IS THE TRUE ENGINE OF THE ECONOMY

Actually, every five years the Commerce Department presents detailed statistics that reflect the activities in the whole economy, including intermediate goods. They are titled "Input-output accounts for the U.S. economy." The latest data, published in the February 2002 issue of the *Survey of Current Business*, are available for 1998.

They show that gross national output, including intermediate inputs, was 76% higher than GDP. Of that total, consumption accounted for 38%, far less than what the GDP figures suggest (66%). In contrast, total business outlays, including intermediate inputs and gross nonresidential investment, accounted for 53% of total spending, as against 12.5% in GDP.

The most important insight to be derived from these reflections is that a profits squeeze and the related contraction in business spending impact the economy on a far broader range than just capital investment.

What are the main arguments behind the almost uniform recovery forecasts for the U.S. economy? *First and foremost*: better-looking statistics, particularly the unexpected fourth-quarter 1.7% GDP increase and the recent spurt in consumer confidence. *Second*, unusually speedy interest rate cuts, tax cuts and inventory liquidations by businesses essentially make for an equally speedy recovery. *Third*, the consumer remains resilient. *Fourth*, the New Economy lives on in the productivity miracle ensuring big future gains in profits.

These make a formidable list of arguments speaking for the U.S. economy's recovery. Unfortunately, none of them is conclusive, and some are dead wrong — above all the forecast for a strong profit recovery.

THE ILLUSORY RECOVERY

We recognize a lot of fudge in presenting and reading the statistics. For example, the increases in the monthly payroll numbers during the last few months regularly resulted from a downward revision of the prior month, totaling 220,000 between September and March.

Just as conspicuous is the misreading of reports due to the habit of focusing on only one or two headline numbers. In late March, the Commerce Department's Bureau of the Census pleased the markets with the news that orders for manufactured durable goods had risen $2.7 billion, or 1.5%, in February. The report stressed this was the third consecutive monthly increase. In reality, the picture was grossly distorted by steep increases in orders for aircraft and aircraft parts (41%) and defense (78%).

The big question concerning recovery or a return to recession at this point is, who will carry the day? Will the lavishly spending consumer pull the business sector out of its retrenchment, or will the business sector abort the consumer's efforts? Apparently, expectations are running high that the consumer will get the better of businesses and tip the scale in favor of economic recovery.

Last but not least, in the back of most people's minds there remains the implicit conviction that the combination of the Fed's aggressive rate cuts and the government's equally aggressive tax cuts simply cannot fail to positively impact the economy. Never before have the authorities used such massive monetary and fiscal stimuli to attack economic weakness.

Given also a general conviction that the U.S. economy is in the best of possible health (as evidenced by low inflation rates), a failure of these stimulus measures is simply inconceivable for most American economists. And hasn't the U.S. economy defied dismal warnings again and again with its notorious dynamism, flexibility and resilience?

Besides, American economists are great believers in the efficacy of monetary policy. In their view, America's Great Depression as well as Japan's present, prolonged recession have been caused mainly by the central banks' failure to ease quickly and strongly enough. That's a fault that Alan Greenspan clearly cannot be accused of.

THE MARKETS OBSTRUCT

Yet there are momentous reasons suggesting that the Fed's easing, however aggressive, is effectively being aborted through negative reactions of the markets. It takes a fairly long time before the effects of monetary policy reach all corners of the economy. This is because the federal funds rate (which the Fed sets) impacts the economy not so much directly but through four important channels: availability of credit, lower longer-term market rates, rising asset valuations and a lower exchange rate.

Depending on circumstances, the primary effects of monetary easing on these variables may be strong or weak. The important fact to see is that the responses of the markets are not only unusually weak, but they are outright negative, essentially blunting the monetary easing's impact on the economy. This is without precedent.

While the money and credit spigot are wide open, the other three transmission variables determined by the markets — longer-term interest rates, stock prices and the exchange rate — have all moved opposite to their desired reaction.

In essence, the cost of capital or credit has risen for most firms. Worrying about a possible credit crunch, even top-rate companies such as GE have been replacing cheap short-term credit from banks and the commercial paper market with far more expensive longer-dated bonds. For the first time ever, American businesses are passing through a period of economic weakness without the usual benefits to their bottom line from falling interest expenses.

BURNING THE FURNITURE FOR FUEL

Assessing the profit prospects of U.S. corporations, still another point has to be borne in mind: For many years they systematically ravaged their balance sheets by massive stock buybacks and the acquisition mania, implying higher interest costs in the future.

What's more, the soaring indebtedness had its counterpart on the assets side in exploding, profitless goodwill — the difference between what a company pays to acquire another and the net worth of the acquisition as reported on its balance sheet. Over the past 50 years, tangible assets such as structures, equipment and inventories of U.S. nonfinancial corporations have plunged as a share of total assets from 78% to 53%.

For any reasonable observer, it was blatantly obvious right from the beginning that these corporate policies aimed at boosting profits per share in the shortest possible time were essentially destructive for balance sheets and profits in the long run.

Still, pointing to a rate of money and credit growth that vastly exceeds GDP growth, many regard the Fed's monetary loosening as a sweeping success. In the past, indeed, this has always been the reliable harbinger of economic recovery and a full-fledged bull market in stocks. *"Liquidity conditions in America have rarely been so bullish for financial markets,"* wrote the London *Economist* recently.

Though a widespread view, it is nevertheless a gross misjudgment. What we see in this rampant money and credit growth is rather a reflection of escalating illiquidity.

THE CREDIT-GDP LINK HAS BROKEN DOWN

Hefty increases in the money supply in the past have, indeed, never failed to push both the economy and asset markets upward. Why should it fail this time? Well, a sharply rising money supply used to fuel inflation. But that link broke down in the 1980s. Instead, "excess" money — that is, broad money growth in excess of GDP growth — began to spill primarily into equity prices.

During the last two years, "excess" money has been expanding faster than ever before. Yet it neither helped the stock market nor the economy. Could it be that these former relationships have broken down, too? We think they have, and for identifiable reasons.

In terms of quantity of money and credit creation, the Fed's easing has been a sweeping success. But in terms of its effects on GDP, national income and the financial markets, it is an outright disaster. These are, of course, the only effects that matter.

Last year, U.S. national income grew by $178.6 billion. Debts, on the other hand, increased more than $2 trillion. Debts of the nonfinancial sector were up $1.1 trillion, and debts of the financial sector by $916 billion. All in all, debts rose more than 10 times faster than income. Broad money, by the way, increased $882.7 billion. Consider that barely 9% of the total credit creation in 2001 translated into GDP and income growth.

Debt and credit growth is the key source of demand and income creation in every economy. But this correlation depends entirely on the kind of spending that it finances, and that can differ immensely.

To quote Joseph Schumpeter on the subject: *"The effects of credit creation are not simply or primarily a question of quantity, but mainly depend on the purposes which credit creation serves and on the success that attends these purposes. It's a fact that some of our contemporaries have made every effort to obscure."*

The former close link between monetary aggregates, GDP and inflation rates had its basic cause in the fact that the bulk of the proceeds of consumer and business borrowing was spent on goods and services that implicitly translate into growth of national income and GDP. Business borrowing was mainly for the creation of new capital.

But this close linkage of money and credit supply with GDP growth and the inflation rates began to weaken in the 1980s. During the 1990s, it has definitely broken down. Why?

Money and credit creation in the United States has been increasingly diverted into three outlets that do not produce domestic income and spending: *first*, the soaring merchandise imports; *second*, the big shift in corporate strategies of expansion towards mergers and acquisitions and away from capital creation through building new factories; and *third*, unbridled financial speculation. Essentially, inflation shifted from GDP to the asset markets.

In short, it is the purpose for which credits are used that ultimately matters for its effects on the economy. Principally, the preposterous disparity between debt growth and income growth in the United States has its decisive cause in a momentous shift in the use of credit. The bulk of the debts are incurred as a consequence of expenditures that in no way involve economic activity and income creation.

In the fourth quarter of last year, the consumer increased his outstanding debt by $610 billion, but his spending on goods and services increased by only $120.6 billion. Businesses borrowed $377.5 billion while cutting their outlays on fixed investment and inventories by $163.3 billion.

A SINKHOLE OF DEBT

Why all this borrowing for so little spending? Are they perhaps bolstering their liquidity for future spending? A closer look suggests that their borrowing rather reflects escalating illiquidity.

As to businesses, we note two obvious main causes: business losses and shrinking cash flow. While business profits are still positive in the aggregate, quite a few firms are incurring losses that have to be met by credit. Financing losses absorbs as much credit as financing an equal amount of investment, but it has nil effect on GDP.

Scanning U.S. business finances, we note furthermore that undistributed profits of nonfinancial corporations, from which dividends are normally paid, were –$167 billion in the fourth quarter, as against $79 billion in the third quarter of 2000. The inherent implication: a rapidly rising part of dividends has to be paid with borrowed money.

But pondering the causes of the chronic, huge discrepancy between debt growth and GDP growth, we suspect still another one of utmost importance: an escalating Ponzi financing. That is, debtors have largely stopped financing their interest service out of current income, meeting it instead by further borrowing. Interest service is simply capitalized as additional debt.

To get an idea of the possible amount of Ponzi financing, we did a simple calculation: At the end 2001, outstanding credit in the United States totaled almost $29 trillion. How much interest may this monstrous indebtedness presently require? It can't be far from $2 trillion annually. Strikingly, this amount roughly corresponds with the recent annual credit growth. Rapidly rising unpaid compound interest appears to keep the American credit machine running at full speed — also outside of GDP.

AMERICA'S IMBALANCE SHEET

In conclusion, the former close link between movements of the monetary aggregates and movements of GDP and national income has clearly broken down. And just as clear is its cause: For a variety of identifiable reasons, only a fraction of the current money and credit supply is making its way into the real economy and its income circulation.

Overwhelmingly, the rampant flows of money and credit are gobbled up by the wildly expanding financial system, which has turned into a virtual liquidity Molech that requires huge amounts of new credit just to stay alive.

We have identified a variety of reasons that account for this disruption of the former close relationship between credit flows and GDP in the United States. However, we hasten to add that we regard them all as symptoms of a much deeper cause.

It is important to realize that there is a basic cause behind these symptoms. These are drastic, structural distortions both in the U.S. economy and its financial system resulting from the extreme credit excesses of the past bubble years. One is a massive shift in the composition of the economy towards an unprecedented record level of private consumption at the expense of saving and capital formation, and the other one is a gross overexpansion of the financial system in relation to the economy.

The Fed's easing has definitely been very successful in one respect: consumer borrowing and spending. The latter rose 3.1% over the full year and 6.1% in the fourth quarter. The dark side of this success is that the personal saving rate fell to a new low of 0.4% of disposable income.

In general, we read nothing but positive reports about the consumer and his ability to further increase his spending. Fears about his finances are discarded as grossly exaggerated. Don't worry about his record-high debts; in reality his net worth has soared during the last few years due to much faster rises in stock and house prices.

At the end of 2001, real estate holdings of private households were valued at almost $12 billion, up from $7.6 billion in 1995. Holdings of equities and mutual fund shares were valued at nearly $10 billion, up from about $5.3 billion in 1995.

Over the same period, consumer liabilities have increased from $5 billion to $7.7 billion.

Though this represented a stunning surge of well over 50%, nevertheless the much faster housing and stock price inflation boosted the net worth of private households from $27 trillion to around $40 trillion.

Nor, according to this view, is there any reason to worry about the collapse in the published personal saving rate in recent years. Even Fed economists have dismissed it as a misleading statistical artifact without economic relevance. A true measure of saving, according to their argument, ought to include stock market gains, and by that measure U.S. savings are pretty high by historical standards.

As to the first argument concerning private household balance sheets, it should be clear that everything depends on what is going to happen to U.S. house and stock values. If the economy and business profits fare as well as the consensus expects and predicts them to, the consumer's net worth may hold up. But given the sky-high level of stock valuations, even that is by no means a certainty. We actually regard these forecasts as sheer froth. Investors, consumers and everybody else are in for a big disappointment about the U.S. economy in the course of this year that will shatter the financial markets and with it the net worth of private households.

For sure, Greenspan and Wall Street have been successful in sustaining misplaced, high-riding optimism about the U.S. economy. A striking testament to the prevailing delusion is the dramatic divergence between plunging actual profits and soaring share valuations in the market. Compared to a year ago, earnings per share of companies in the S&P 500 index have plunged from about $50 to about $25. Their valuation, though, surged from 22 to 45 times earnings. Earnings have halved and valuations doubled.

THE KEY ROLE OF SAVING

We come to the most destructive feature of the economic development in the United States: the virtual disappearance of personal saving, comparing with a saving rate around 8% in the early 1990s. It used to be a truism among thinking people that saving in the sense of abstinence from consumption is the primary key requirement for capital formation because it inherently releases the resources that it needs for the production of capital goods.

That's why Adam Smith wrote: *"Parsimony, and not industry, is the immediate cause of the increase of capital."* While investment activity often falls short of available savings, it has to be realized that saving is, on the other hand, the indispensable, vital condition that provides the necessary means of investment. Putting it differently, the volume of available savings sets the limits to possible capital investment. A country without such savings is a country without the possibility of capital formation. Manifestly, the United States has become such a country.

Far from stimulating investment, the extraordinary surge of consumer demand in the United States during the past few years has essentially done the exact opposite — crowding it out. Inexorably, this is culminating in the present investment and profits crisis. In the jargon of the Austrian school, this is capital consumption.

Implicitly, slumping business investment spending translates into slumping employment and consumer incomes. So far, though, the consumer has largely offset this income squeeze by stampeding still faster into debt.

For the time being, this has certainly prevented much worse from happening. But it definitely lacks the necessary thrust to jump-start a recovery. For that to materialize, it requires without question the return of rather strong growth in business fixed investment — which in turn depends on sufficiently positive profit prospects.

RAVAGED PROFITS

Although economists are hailing the U.S. economy's downturn last year as the mildest ever on record, the

profit slump of nonfinancial corporations is already the worst since the 1930s. What's more, it did not start with the economy's downturn, but began years before. Yet it does not seem to be causing any great concern. Forecasts for double-digit profit growth abound, and with them the expectation of triggering a burst in business fixed investment.

In recent months business profits were exposed to strong crosscurrents, among them tax cuts, strong inventory fluctuations and Sept.11-related changes in capital consumption allowances. As always we look at the reported NIPA profits. The net effect of these influences could be a temporary profit improvement, but the major influences that have ravaged profit margins during the past several years remain in full force.

The prevailing, highly optimistic profit forecasts are mainly pinned on the presumption that continuous, stellar productivity growth will keep labor unit costs so subdued that even small advances in prices will go straight into profits.

If productivity growth is such a surefire device for high profits, one has to wonder why it has so grossly failed in the past few years, while the economy was still booming with consumer and producer prices rising at annual rates between 2-3%.

First of all, we have to say that we regard the reported productivity numbers largely as statistical bogus. But our highly negative assessment of the U.S. economy's profit performance in the past, present and future has entirely other reasons. This common, narrow focus on productivity growth as the main source of profits is badly flawed.

The key causes for this protracted, poor profit performance lie basically in the extremely unbalanced structure of U.S. economic growth. One reason is record-low net investment, and another is the record-high trade deficit.

At the macro-level, all business revenue accrues from business expenditures, both consumer spending and the crucial one, business investment. But there is a crucial difference between the two types of spending in their effect on profits. Consumer spending mainly accrues from wages and salaries that have been a business expense. In contrast, business spending on capital investment produces business revenue but no expense because these expenditures are capitalized. Expenses occur over time through deprecation charges. Due to this accountancy, net fixed investment is typically the largest and most important profit source.

Focusing on the different flows that increase or decrease aggregate business profits, we identify two main causes of the U.S. economy's protracted, poor profit performance: low and declining net fixed investment and the horrendous trade deficit.

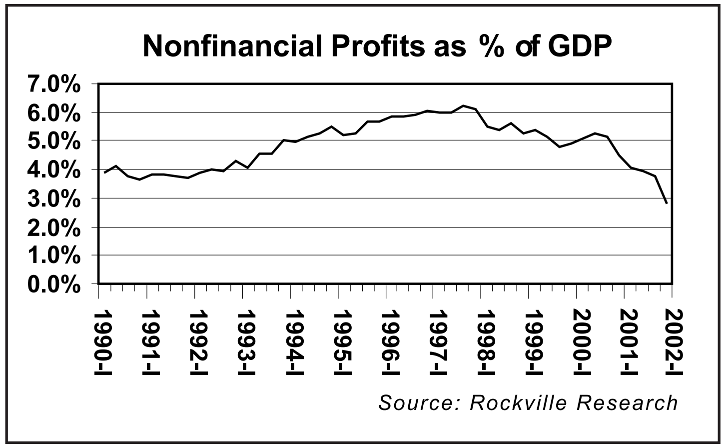
We realize that this statement grossly conflicts with the prevalent perception of a preceding investment boom. But that statistical appearance owed everything to the hedonic pricing of computers. More precisely, there was too much merger and acquisition activity at the expense of new investment, and inherently at the expense of profits.

The true counterparts to the rampant consumption boom in the late 1990s were sizable underinvestment in traditional manufacturing and over- and malinvestment in the new information technology.

In a public speech, Mr. Greenspan hailed the fact that the new high-tech contributed two-thirds of the increase in manufacturing output between 1995-2000. We think this fact is rather testament to a gross, unsustainable imbalance in the economy's production pattern.

The single biggest profit killer since 1997 has probably been the trade deficit, which has exploded from $140 billion to more than $400 billion. It has to be considered that most of the money paid to foreign producers comes from the wage bill of U.S. businesses. To this extent, they have an expense but no revenue.

Measured as a share of GDP, before-tax profits of nonfinancial corporations have slumped in the course of last year to their lowest level in the whole postwar period; to wit, below 3%. This compares with around 9% in the 1960s. During the following years, it hovered between 5-6% of GDP, hitting a low of 4% during the 1990-91 recession.



Yet as bad as the picture looks in the aggregate, it actually conceals the worst part of the problem, and that's a dramatic shift in corporate earnings between manufacturing and retail trade.

During the recession year of 1991, as shown in the chart on page 2, manufacturing before-tax profits amounted to $93.5 billion and retail trade profits to $27.7 billion. In the fourth quarter of 2001, manufacturing profits had almost halved to $50.3 billion, while retail trade profits had more than trebled to $84.5 billion.

But even within the manufacturing sector, there is tremendous divergence. The profits crisis is strikingly centered in the durable goods sector, showing a net loss of $12 billion for the fourth quarter, as against a net profit of $62 billion for the nondurable sector. The worst losers are automobiles, industrial machinery and equipment, and electronics and other electric equipment. In other words, the investment sector.

CONCLUSIONS:

American credit and debt excesses continue to run unabated. But the quandary is that the economy and the financial markets are getting very little or no bang at all from it. Referring to the quote on the first page: An overexpanded colossus of debts requires enormous amounts of new credit just to keep depression and a liquidity crisis at bay.

In essence, this gross mismatch between debt growth and economic activity suggests that the Fed's aggressive easing is a complete failure. By accommodating the escalating debt spiral, the Fed prevents overdue foreclosures, but the final result is accumulating illiquidity.

The latest message from Corporate America is unmistakable. Statistical rebound or not, the profits carnage continues in full force, implying much worse to come for the economy and the markets. There will be a rude awakening.

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